

# Contracting on Litigation\*

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## Abstract

Two risk-averse litigants with different subjective beliefs negotiate in the shadow of a pending trial. Through contingent contracts, the litigants can mitigate risk and/or speculate on the trial outcome. Contingent contracting decreases the settlement rate and increases the volume and costs of litigation. These contingent contracts mimic the services provided by third-party investors, including litigation funders and insurance companies. The litigants (weakly) prefer to contract with risk-neutral third parties when the capital market is transaction-cost free. However, contracting with third parties further decreases the settlement rate, increases the costs of litigation, and may increase the aggregate cost of risk bearing.

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# 1 Introduction

■ This article studies contingent settlement contracts in litigation, exploring both the deals that are struck between the litigating parties themselves and their agreements with outside investors. Traditionally, scholars have viewed settlement as a simple transfer payment from a defendant to a plaintiff in exchange for the plaintiff abandoning a claim.<sup>1</sup> But in reality, parties can and often do write detailed contracts before trial that turn on the future trial outcome. We explicitly account for this by allowing litigating parties to write general contracts with each other that are contingent on the outcome of litigation. Then, placing lawsuits into a market context, we compare these “inside” contracts to the “outside” contracts offered by competitive third-party investors. Although inside and outside contracts create value in similar ways, we show that contingent contracts between the litigants themselves may lead to relatively fewer trials, less wasteful litigation spending, and less aggregate risk.

Contingent settlement contracts appear in many different legal contexts and take a variety of forms. Consider the following examples: In an automobile liability case, a \$125,000 jury award was reduced to just under \$94,000 because the parties agreed in advance to a 75%/25% split of any court-awarded damages.<sup>2</sup> In a high-stakes medical malpractice case, a \$30 million jury award was reduced to \$5.3 million pursuant to a “high-low” contract signed by the parties before trial.<sup>3</sup> In yet another lawsuit, the parties agreed to a damages payment of \$6,000 if the jury found the defendant to be less than 50% at fault, \$11,250 if she were found to be exactly 50% at fault, and \$22,500 if she were more than 51% at fault.<sup>4</sup> Contingent contracts with third-party financial service providers, including insurance companies and litigation funders, have become increasingly common as well.

This article explores the positive and normative implications of contingent settlement agreements in a model with two risk-averse parties, a plaintiff and a defendant. At trial, the factfinder (who may be a judge, a jury, or an arbitrator) will award damages. Trials are costly and risky, and the parties have potentially different subjective beliefs about the likely outcome. The parties’ subjective beliefs, preferences, and litigation costs are assumed to be common knowledge, so negotiations take place under complete information. The parties may decide to

<sup>1</sup>Surveys include Spier (2007) and Daughety and Reinganum (2012).

<sup>2</sup>*Palimere v. Supermarkets Gen.*, No. 05186, 1989 WL 395822 (Pa. Com. Pl. Dec. 1989) (Verdict and Settlement Summary).

<sup>3</sup>Andersen (2013). With a high-low agreement, the “defendant agrees to pay the plaintiff a minimum recovery in return for the plaintiff’s agreement to accept a maximum amount regardless of the outcome of trial” (Garner, 2004).

<sup>4</sup>*Claudia Clemente v. Lisa Duran*, 2006 WL 4643243 (N.J.Super.L.) (Verdict and Settlement Summary).

completely settle out of court, thereby ending the dispute and avoiding the risks and costs of trial. Through a simple out-of-court settlement, the defendant is effectively purchasing 100% of the plaintiff's risky legal claim. Alternatively, the parties may "agree to disagree" and bring the dispute to trial. In this environment, the litigating parties may enter into contingent agreements with each other and/or with outside investors.

First, ignoring the external capital market, we show that the parties will write an inside contract that specifies a lump-sum payment and a contingent payment that is monotonic in the likelihood ratio of their subjective beliefs. If the parties have CARA expected utility and their beliefs are normally distributed with divergent means, then the defendant pays the plaintiff a guaranteed lump sum and a fixed proportion of the court-determined damages. These contingent settlement contracts bear a striking resemblance to the financial contracts traditionally offered by third-party investors. Through the contingent settlement contract, the defendant is in effect buying a partial equity stake in the plaintiff's claim. Similarly, through the contract, the plaintiff is effectively selling an insurance policy to the defendant.

Finally, we allow the litigating parties to write contingent contracts with outside investors. These investors are risk neutral, share common beliefs, and operate in a competitive environment. In these idealized circumstances, the litigating parties jointly prefer to write financial contracts with third-party investors rather than with each other (although this preference is weak). Because the parties perceive themselves to be better off with the backing of outside investors, some cases that would otherwise have settled will go to trial instead. Thus, with outside investors, the settlement rate falls and the litigation rate rises. Interestingly, we show that the optimal contracts with outside investors may actually expose the litigating parties to more risk rather than less. Insofar as these contracts increase both the costs and aggregate risks of litigation, third-party involvement in litigation reduces social welfare.

□ **Litigation Literature.** This article takes the literature on the economics of litigation in a new direction. Many scholars have argued that settlement negotiations may fail when the parties have divergent beliefs or non-common priors about what will happen at trial (Landes, 1971; Posner, 1973; Gould, 1973; Shavell, 1982; Bar-Gill, 2006).<sup>5</sup> In these models, as here, the litigants are stubborn, and do not update their beliefs when confronted with the differing opinions of others.<sup>6</sup> Other

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<sup>5</sup>Such models have been used in empirical work on litigation (Waldfogel, 1995) and employed to explore fee-shifting (Shavell, 1982), case selection (Priest and Klein, 1984), bifurcation (Landes, 1993), and tort reform (Babcock and Pogarsky, 1999; Landeo et al., 2013).

<sup>6</sup>Other articles explore learning in conjunction with optimism (Yildiz, 2004; Watanabe, 2005;

scholars have explored bargaining failures in settings where the parties are asymmetrically informed about what will happen at trial (Bebchuk, 1984; Reinganum and Wilde, 1986; Spier, 1992).<sup>7</sup> With a few notable exceptions discussed below, the literature has not considered the possibility of contingent settlement contracts in litigation. This is a significant oversight, as contingent settlement contracts are both implied by theory and used in practice.

Prescott and Spier (2016) document a broad range of contingent settlement contracts, including agreements that specify shares of liability and litigate damages only, and agreements to modify or place bounds on damages payments.<sup>8</sup> In a sample of more than 2,700 cases from New York State’s summary jury trial program, Prescott and Spier (2016) show that approximately eighty percent had high-low agreements (a particular type of contingent settlement contract).<sup>9</sup> Using insurance claims data from a large national insurance company, Prescott et al. (2014) show that contested insurance claims with above-median risk were four to five times more likely to use high-low agreements than claims with below-median risk. This latter article also illustrates the value of these agreements in a simple binary model with two possible trial outcomes. The current article crowns our prior work by considering general distributions of trial outcomes, general contingent settlement contracts, and the role of third-party investors.<sup>10</sup>

The last several years have seen the growth of companies that specialize in investing in lawsuits (Garber, 2010; Steinitz, 2012). In a model with asymmetric information and risk-neutral parties, Daughety and Reinganum (2014) argue that third-party litigation funding can mitigate asymmetric information problems, thereby reducing bargaining failures and increasing the settlement rate.<sup>11</sup> By contrast, we find that bargaining failures are more common and settlement less likely with third-party litigation funding. In our model, risk-averse litigants benefit from shifting risk and speculating through outside investors, which in turn makes trial more likely.<sup>12</sup> The literature on liability insurance focuses on policies

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Yildiz and Vasserman, 2016).

<sup>7</sup>The plaintiff may have better information about the magnitude of the harm they have suffered whereas the defendant may know more about who is liable. In Farmer and Pecorino (1994) and Heyes et al. (2004), parties privately observe their risk preferences.

<sup>8</sup>Examples include 90%/10%, 80%/20%, 70%/30% and 50%/50% splits (among others). See Prescott and Spier (2016).

<sup>9</sup>High-low contracts are featured in several state-sponsored alternative dispute resolution programs (Hannaford-Agor, 2012).

<sup>10</sup>Lavie and Tabbach (2017) build on Prescott and Spier (2016) by exploring contingent contracting in a model with one-sided private information. Spier (1994) analyzes direct-revelation mechanisms with two-sided private information. These approaches are complementary to ours.

<sup>11</sup>Avraham and Wickelgren (2014) argue that the terms of a litigation funding contract may signal the plaintiff’s private information to the court. They do not consider settlement.

<sup>12</sup>Contingent fees with lawyers may also more efficiently allocate risk (Danzon, 1983) and

acquired before an accident arises,<sup>13</sup> although the possibility of after-the-event insurance has also been explored (Molot, 2009). These articles do not explore the role of divergent prior beliefs or the implications for aggregate risk bearing.

□ **Divergent Prior Beliefs.** Our article is part of a broader theoretical literature on contracting with non-common prior beliefs. See Morris (1995) and Köszegi (2014). There are a number of recent articles in the financial economics literature that are related to ours. Weyl (2007) and Dieckmann (2011) show that insurance markets for rare events can increase aggregate risk when parties have divergent beliefs. Simsek (2013) shows that new financial products will cause traders to increase their bets on existing financial assets, thus amplifying portfolio risk. Our result that contingent settlement contracts with outside litigation funders and suppliers of capital may increase aggregate risk is in the same spirit.

There are different ways that one can evaluate welfare in models with divergent prior beliefs. First, one might simply consider the subjective well-being of the litigants themselves. With this approach, if the parties perceive themselves to be jointly better off going to trial, then one would say that welfare is higher. Second, one might instead evaluate the well-being of the litigants using a single, objective truth (as in Weyl, 2007; Sandroni and Squintani, 2007; Brunnermeier et al., 2014). This second approach explicitly recognizes that with divergent beliefs, not everyone can be correct.<sup>14</sup> We present both approaches. First, we analyze the effects of inside and outside contracts on the subjective well-being of the litigants, using their divergent beliefs. Next, we analyze these effects using a single set of objective, true beliefs. For the latter, we follow Brunnermeier et al. (2014) and assume that the objective truth is any convex combination of the beliefs of the parties themselves. Our results do not depend on the particular weights applied.<sup>15</sup> So although it might be natural to assume that the capital market has unbiased beliefs, this is not required for our results.

Our assumption that parties hold different subjective beliefs is empirically relevant. Indeed, according to DeBondt and Thaler (1995), “perhaps the most robust finding in the psychology of judgment is that people are overconfident.” In a controlled laboratory setting where subjects were randomly assigned to the roles of plaintiff or defendant, Loewenstein et al. (1993) find strong evidence of self-serving assessments that were correlated with settlement breakdowns and

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overcome agency problems (Rubinfeld and Scotchmer, 1993; Dana and Spier, 1993).

<sup>13</sup>In many cases, insurance companies act as proxies for defendants in litigation (Sebok, 2014).

<sup>14</sup>Note that if the parties themselves were choosing a social welfare function from behind a veil of ignorance, before their beliefs are formed, then the parties would choose this second, admittedly paternalistic, approach.

<sup>15</sup>In particular, the true beliefs may coincide with those of the outside investors.

trial. Eigen and Listokin (2012) find evidence of optimism bias in a natural experiment where subjects were randomly assigned sides in moot court cases. These experimental findings are not consistent with asymmetric information. In a study of practicing litigators, Goodman-Delahunty et al. (2010) find that lawyers with more years of experience exhibit the very same overconfidence as their less experienced counterparts, and that overconfidence does not wane as the time to trial becomes shorter.<sup>16</sup> In practice, divergent beliefs appear to be both commonplace and persistent.

Our analysis delivers several empirical predictions. First, contingent contracts will tend to be flatter (less sensitive to the trial outcome) when the risk of trial is larger, when the parties are more averse to risk, and when the parties have more aligned beliefs. Second, our model predicts that contracting on litigation between the litigants themselves may be more common in cases when the market for third-party funding is limited by transactions costs or law.<sup>17</sup> Indeed, restrictions on litigation funding vary by jurisdiction, with participants variously being subject to usury laws, champerty restrictions, and rules of professional responsibility and ethical guidelines.<sup>18</sup> Finally, when the market for third-party funding is limited, fewer lawsuits will go to trial and, for those that do go to trial, the aggregate risk borne by the participants may be lower.

The outline of the article is as follows. The next section presents the basic model and solves for the equilibrium outcomes of the three regimes: naked trials, inside contracts, and outside contracts. For each regime, we evaluate the parties' decision to settle versus litigate, the risks and the costs of litigation. Section 3 presents the social welfare analysis, analyzing the private subjective benefits of litigation and the social costs of litigation across the three contractual regimes. Section 4 offers concluding remarks. All proofs are in the Appendix.

## 2 The Model

■ Suppose that there are two parties to a dispute, a plaintiff ( $p$ ) and a defendant ( $d$ ), who are negotiating prior to a trial. If the case goes to trial, the court will

<sup>16</sup>Relatedly, Wistrich and Rachlinski (2013) present evidence that lawyers and judges are susceptible to confirmation bias.

<sup>17</sup>This may be consistent with the observed popularity of partial settlement contracts in the small stakes cases in Prescott and Spier (2016). Note, however, that there may be fewer lawsuits in jurisdictions where litigation funding is prohibited.

<sup>18</sup>See Steinitz (2012). In practice, litigation funders may exert various types and degrees of control through staged financing, duties to cooperate, and other mechanisms. Insurers may acquire control through assignment or subrogation (Sebok, 2014).

order a transfer of  $x$  from the defendant to the plaintiff and the parties will bear litigation costs  $c_d$  and  $c_p$ . The parties have CARA expected utility functions,  $u_i(z) = -\exp(-a_i z)$  where  $a_i > 0$ ,  $i = p, d$ , are the coefficients of absolute risk aversion for the parties.<sup>19</sup> The parties to the dispute may choose to negotiate a full settlement before trial, where the defendant pays a fixed amount and the plaintiff withdraws the complaint. A full settlement completely ends the dispute, avoiding the risks and the costs of litigation. We assume that the plaintiff has a credible threat to litigate.<sup>20</sup>

The litigants have potentially different subjective beliefs about the probability distribution of the court's award,  $f_i(x)$ ,  $i = p, d$ . Unless specified otherwise, we assume that these beliefs are normally distributed with means  $\mu_p$  and  $\mu_d$ , respectively, and common variance  $\sigma^2$ .<sup>21</sup> Later, we will introduce a competitive capital market with risk-neutral investors who share the common belief that the court award  $x$  is distributed with mean  $\mu_0$  and variance  $\sigma^2$ . We assume the distributions, litigation costs, and risk aversion coefficients are all common knowledge so there is no learning over time.<sup>22</sup>

We analyze three different contractual settings. First, as a benchmark, we consider “naked trials” where the parties cannot write contingent contracts with each other or with third parties. At the conclusion of trial,  $x$  is transferred from the defendant to the plaintiff. Second, we consider litigation with “inside contracts,” where the parties can agree before trial to modify the court's award so that  $s(x)$  is transferred instead of  $x$ .<sup>23</sup> Third, we consider litigation with “outside contracts,” where each party can write contingent contracts with investors from the external capital market. So, for example, the plaintiff might agree to sell shares of any award received in the case to outside investors, and the defendant might agree to purchase an insurance policy.

For each setting, we characterize the set of subjective Pareto-optimal con-

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<sup>19</sup>Large corporate defendants, or defendants who have been replaced by diversified insurance companies, may be less risk averse than small plaintiffs. Note, however, that corporations are managed by risk-averse agents who are concerned about career prospects and performance pay.

<sup>20</sup>If the plaintiff did not have a credible threat to litigate, the defendant would refuse to negotiate and the case would be dropped. Contracting with third parties may strengthen the plaintiff's bargaining position. We will discuss this possibility below.

<sup>21</sup>Technically, with these densities, the court award could be negative. Because the slope of the optimal contract in (5) depends on the natural logarithm of the ratio of the densities, our results would hold if we truncated the densities at zero.

<sup>22</sup>The beliefs of the litigants and the capital market are modeled as primitives. Alternatively, beliefs could be modeled as randomly drawn signals. Our parties are decidedly not Bayesian – they do not revise their own beliefs as they learn about the signals of others.

<sup>23</sup>Equivalently, the contract could specify side payments,  $\tau(x)$ , from the plaintiff to the defendant after the payment of the damage award  $x$ . Specifically,  $\tau(x) = x - s(x)$  would require the plaintiff to return the damage award  $x$  to the defendant but keep an amount  $s(x)$ .

tracts. That is, given the parties' divergent subjective beliefs, we describe the set of contracts where it is impossible to make one party subjectively better off without making the other party subjectively worse off. In designing their contracts, the parties trade off their desire to hedge risk and their desire to speculate and gamble on the trial. Our concept of Pareto optimality shows the utmost respect for the divergent subjective beliefs of the parties. For each setting, we quantify the joint subjective value the parties derive from going to trial and the level of risk that they jointly bear, and characterize the parties' decision to fully settle out of court or go to trial. We adopt the generalized Nash bargaining solution where the defendant captures share  $\pi \in [0, 1]$  and the plaintiff captures share  $1 - \pi$  of any bargaining surplus.<sup>24</sup>

We also evaluate welfare in the three contractual settings using a single, objective assessment of the truth. With this approach, the subjective value that the litigants think that they are getting from the trial does not reflect a legitimate social benefit. Following Brunnermeier et al. (2014), we assume that the true distribution of the court award is a convex combination of the parties' beliefs.<sup>25</sup> Specifically, we assume that the truth is normally distributed with mean  $\mu_t$  and variance  $\sigma^2$ . The "truth"  $\mu_t$  may coincide with the beliefs of the plaintiff ( $\mu_t = \mu_p$ ), the beliefs of the defendant ( $\mu_t = \mu_d$ ), or the beliefs of the capital market ( $\mu_t = \mu_0$ ), or it could differ from all three.

As we will see, our results regarding the aggregate risks from inside and outside contracts do not depend on the precise value of  $\mu_t$ . Our welfare results hold regardless of whose beliefs are correct. To be sure, it is natural to imagine that corporate defendants, big insurance companies, and Wall Street financiers, are more sophisticated and less subject to optimism and self-serving biases than small plaintiffs. After all, large commercial litigation investors are repeat players. In this case, it may well be the case that the outside investors have more accurate beliefs than the litigants themselves. But our model's implications for the subjective benefits of private contracting and the aggregate level of risk bearing would be valid even if this were not true.

□ **Naked Trials.** Suppose that the parties choose between a full settlement and a naked trial. With our assumptions on preferences and normally-distributed beliefs, the least the plaintiff would be willing to accept in settlement is  $\underline{s} = \mu_p - a_p \sigma^2 / 2 - c_p$ .<sup>26</sup> This is the plaintiff's expected value of the court award,

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<sup>24</sup>This is equivalent to a random-offeror model where the defendant makes a take-it-or-leave-it offer with probability  $\pi$ .

<sup>25</sup>Brunnermeier et al. (2014) define the set of "reasonable beliefs" to be the set of convex combinations of the beliefs of the parties themselves.

<sup>26</sup>This is a standard implication of the CARA-normal framework and will not be reproduced



evaluated at the plaintiff's subjective belief, minus the risk premium and litigation cost. Similarly, the most the defendant would be willing to pay in settlement is  $\bar{s} = \mu_d + a_d\sigma^2/2 + c_d$ . If  $\underline{s} \leq \bar{s}$  the parties will agree to settle out of court for some amount  $s \in [\underline{s}, \bar{s}]$ , avoiding the costs of trial. The parties will go to trial if  $\underline{s} > \bar{s}$ , or

$$c_p + c_d < B^N(\mu_p, \mu_d, a_p, a_d, \sigma^2) = (\mu_p - \mu_d) - (a_p + a_d)\sigma^2/2. \quad (1)$$

The left-hand side of this expression is the joint cost of trial. The right-hand side,  $B^N(\cdot)$ , is the joint benefit of trial, as perceived by the parties. The first term is their joint benefit of speculation, and the second term is the sum of their risk premiums. If the parties had the same beliefs or were mutually pessimistic,  $\mu_p - \mu_d \leq 0$ , then  $B^N(\cdot)$  is negative and the case would surely settle.<sup>27</sup> But if the parties are sufficiently optimistic, so  $\mu_p - \mu_d$  is positive and large, then the case will go to trial.

Although the parties may find trial mutually attractive based on their subjective beliefs, trials are wasteful from a social welfare perspective. When evaluated using the “true” objective beliefs,  $\mu_t$ , the plaintiff's certainty equivalent of a trial is  $\mu_t - a_p\sigma^2/2 - c_p$ , and the defendant's certainty equivalent is  $\mu_t + a_d\sigma^2/2 + c_d$ . Subtracting these expressions, the net social value of a naked trial is negative and equal to  $-(a_p + a_d)\sigma^2/2 - (c_p + c_d)$ . Letting  $R^N(\cdot)$  denote the sum of the risk premiums,

$$R^N(a_p, a_d, \sigma^2) = (a_p + a_d)\sigma^2/2, \quad (2)$$

and the social value of a naked trial is

$$S^N(a_p, a_d, \sigma^2) = -R^N(a_p, a_d, \sigma^2) - (c_p + c_d). \quad (3)$$

Trials are socially wasteful because they impose both risks and costs on the parties.<sup>28</sup> Note that in our benchmark case, social welfare does not depend on the parties' subjective beliefs  $\mu_p$  and  $\mu_d$ . Later, when financial contracts are introduced, social welfare will depend on these parameters indirectly (as the parties' beliefs influence their choice of contract).

□ **Inside Contracts.** We now allow the two parties to the dispute (the insiders) to contract with each other before trial, but we do not allow them to write contracts with third parties. Under the terms of the contract  $s(x)$ , the defendant

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here. See, for example, Grossman (1976).

<sup>27</sup>With generalized Nash bargaining the case would settle for  $\pi\underline{s} + (1 - \pi)\bar{s}$ .

<sup>28</sup>Using equations (1), (2), and (3), the litigants' joint subjective value of a naked trial is  $B^N(\cdot) - (c_p + c_d) = (\mu_p - \mu_d) - (a_p + a_d)\sigma^2/2 - (c_p + c_d) = (\mu_p - \mu_d) + S^N(a_p, a_d, \sigma^2)$ . If  $\mu_p > \mu_d$ , the litigants' joint subjective value is clearly larger than the social value.

will pay  $s(x)$  to the plaintiff. This contract overrides any court award,  $x$ . Using the parties' subjective beliefs, Pareto optimality requires that  $s(x)$  maximize a weighted sum of the parties' expected utilities:

$$\beta \int u_p(s(x) - c_p) f_p(x) dx + (1 - \beta) \int u_d(-s(x) - c_d) f_d(x) dx$$

where  $\beta \in (0, 1)$  and  $(1 - \beta)$  are arbitrary weights.<sup>29</sup> Maximizing this expression pointwise, we have  $s(x)$  implicitly solves  $\beta u'_p(s(x) - c_p) f_p(x) - (1 - \beta) u'_d(s(x) - c_d) f_d(x) = 0$  for all  $x$ , so  $s(x)$  satisfies

$$\frac{f_p(x)}{f_d(x)} \frac{u'_p(s(x) - c_p)}{u'_d(-s(x) - c_d)} = \frac{1 - \beta}{\beta}. \quad (4)$$

With CARA expected utility, any equilibrium contract will take the form:

$$s(x) = k + \left( \frac{1}{a_p + a_d} \right) \ln \left( \frac{f_p(x)}{f_d(x)} \right) \quad (5)$$

where  $k$  is a constant.<sup>30</sup>

This expression describes the locus of contracts for which there is no alternative contract that makes both parties *subjectively* better off. The contracts in this locus differ from each other only in the fixed payment,  $k$ , a value that will be determined by negotiations between the parties.<sup>31</sup> The shape of the contract depends on the parties' subjective beliefs about the distribution of the court award,  $x$ , and the sum of their risk aversion coefficients,  $a_p + a_d$ . Specifically, the contract  $s(x)$  hinges on the likelihood ratio,  $f_p(x)/f_d(x)$ . If the plaintiff believes that the outcome  $x$  is (relatively) more likely than the defendant does, so  $f_p(x)/f_d(x)$  is larger, then the contract will stipulate a higher payment for that particular realization of  $x$ . Conversely, if the plaintiff believes that an outcome is less likely than the defendant does, so the ratio  $f_p(x)/f_d(x)$  is smaller, then the contract  $s(x)$  will specify a smaller amount. Note that if the distributions exhibit the monotone likelihood ratio property, so higher realizations of  $x$  are more consistent with the plaintiff's subjective beliefs than with the defendant's, then the contract  $s(x)$  will be monotonically increasing in the court's award  $x$ .<sup>32</sup>

<sup>29</sup>Suppose that the plaintiff (for example) were choosing the contract  $s(x)$  to maximize his or her own expected utility subject to the defendant's individual rationality constraint. The resulting Lagrangian would have this form.

<sup>30</sup>See Appendix for a proof.

<sup>31</sup>The plaintiff will prefer a higher fixed payment, and the defendant will prefer a lower one. The constant could be negative, in which case the plaintiff pays the defendant. The relative bargaining strengths of the parties affect the fixed payment, not the variable component.

<sup>32</sup>This situation corresponds to the mutual optimism of the two parties.

With normally-distributed beliefs, the equilibrium inside contract  $s(x)$  is linear in the court's award,  $x$ , and satisfies

$$s(x) = s_0 + s_1x \quad \text{where} \quad s_1 = \frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} \quad (6)$$

and  $s_0$  is a negotiated constant which depends on the bargaining power of the two parties.<sup>33</sup> (See Appendix for a proof.)

When  $\mu_p > \mu_d$ , so the plaintiff believes that the average court award is higher than the defendant does, then the slope of  $s(x)$  is positive. When the parties are sufficiently risk averse, the slope of the contract is smaller than one, so the subjectively optimal contract imposes less risk on the parties than a naked trial does. When the parties are not too risk averse and/or are sufficiently optimistic about their own cases, the contract will have a slope that is greater than one.<sup>34</sup> Rather than seeking to mitigate the risk at trial, the parties may find it in their mutual interest to amplify that risk and gamble on the court's award.<sup>35</sup> Amplification also occurs when the variance  $\sigma^2$  is sufficiently small, so the parties have precise (albeit heterogeneous) beliefs.

When  $\mu_p < \mu_d$ , the parties are pessimistic relative to each other and the equilibrium contract has a negative slope. That is, the plaintiff receives less when the court's award is high than when it is low. Although the possibility of a negative slope is interesting in theory, it may not be advisable in practice as a contract with a negative slope would give the parties an incentive to sabotage their own cases.<sup>36</sup> In reality, parties can control the presentation of evidence at trial, and can thus affect the level of damages awarded by the court, factors that are not included the model. So, unless the parties can commit themselves to putting their best cases forward, contracts along these lines would at best be rare.

We now consider the parties' decision to settle out of court or go to trial. To construct the bargaining range, we make use of the following property: If a random variable  $x$  is normally distributed with mean  $\mu$  and variance  $\sigma^2$ , then the random variable  $y = \gamma_0 + \gamma_1x$ , where  $\gamma_0$  and  $\gamma_1$  are constants, is normally

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<sup>33</sup>With more general beliefs, the inside contract would not be linear. If the litigants' beliefs have divergent variances, too, then the optimal inside contract would be quadratic. As discussed later, one can also construct beliefs where the optimal inside contract is a high-low agreement.

<sup>34</sup>In this case, the corresponding transfer would be negative. So rather than the defendant making a lump-sum payment to the plaintiff, the plaintiff would make a lump-sum payment to the defendant for the opportunity to receive the augmented damages.

<sup>35</sup>Contracts that shift litigation costs from the winner to the loser amplify the risk of trial. Fee shifting is common in commercial contracts, although after-the-event fee-shifting is rare. See Donohue (1991).

<sup>36</sup>This is analogous to an athlete betting against their own team and then throwing the game.

distributed with mean  $\mu_y = \gamma_0 + \gamma_1 \mu$  and variance  $\sigma_y^2 = \gamma_1^2 \sigma^2$ . Using this property, the least that the plaintiff is willing to accept in settlement to avoid a trial is  $\underline{s} = s_0 + s_1 \mu_p - a_p s_1^2 \sigma^2 / 2 - c_p$ . Similarly, the most the defendant is willing to pay to avoid a trial is  $\bar{s} = s_0 + s_1 \mu_d + a_d s_1^2 \sigma^2 / 2 + c_d$ . Taken together, the parties will settle when  $\underline{s} \leq \bar{s}$  and will go to trial if and only if  $\underline{s} > \bar{s}$  or, equivalently,

$$c_p + c_d < s_1(\mu_p - \mu_d) - (a_p + a_d)s_1^2 \sigma^2 / 2. \quad (7)$$

The first term on the right-hand side,  $s_1(\mu_p - \mu_d)$ , is the parties' joint subjective benefit from speculation. Because the slope  $s_1$  has the same sign as  $\mu_p - \mu_d$ , the joint value of speculation is necessarily positive. The second term is the sum of the two parties' risk premiums. Importantly, the cost of risk may be higher or lower than the risk of a naked trial. When  $s_1^2 < 1$  the parties are mitigating the risk through their contract, and when  $s_1^2 > 1$  they are amplifying it.<sup>37</sup> Using the equilibrium contract defined in (6), the parties will go to trial instead of settling if and only if

$$c_p + c_d < B^*(\mu_p, \mu_d, a_p, a_d, \sigma^2) = \frac{(\mu_p - \mu_d)^2}{2(a_p + a_d)\sigma^2}. \quad (8)$$

The function  $B^*(\cdot)$  is the joint subjective benefit of litigation with inside contracting. Note that this expression is increasing in the square of the divergence in the parties' beliefs. When the parties disagree about the outcome at trial, they can derive more joint value through speculative contracts. Also note that the joint benefit increases without bound as the sum of their risk aversion parameters approaches zero. Indeed, in the limit,  $B^*(\cdot)$  approaches infinity. With divergent beliefs and a high tolerance for risk, agents can design inside contracts to "pump" considerable value out of their exchange.<sup>38</sup>

Letting  $R^*(\cdot)$  denote the sum of the parties' risk premiums with the equilibrium inside contract defined in (6), we have:<sup>39</sup>

$$R^*(\mu_p, \mu_d, a_p, a_d, \sigma^2) = (a_p + a_d)s_1^2 \sigma^2 / 2 = \frac{(\mu_p - \mu_d)^2}{2(a_p + a_d)\sigma^2}. \quad (9)$$

Note that  $R^*(\cdot)$  depends on the parties' subjective beliefs,  $\mu_p$  and  $\mu_d$ , but not on the truth,  $\mu_t$ . When the parties' subjective beliefs are more divergent (i.e.,  $\mu_p$

<sup>37</sup>The slope  $s_1$  maximizes the joint benefit and thus optimally trades off the parties' need for insurance and their desire to speculate.

<sup>38</sup>Using insurance claims data, Prescott et al. (2014) show that lawsuits with higher-than-average risk are more likely to adopt high-low agreements. Consistent with this, an increase in  $\sigma^2$  corresponds to a higher incremental value of contracting,  $B^*(\cdot) - B^N(\cdot)$ .

<sup>39</sup>The quadratic structure implies  $R^*(\cdot) = B^*(\cdot)$ .

and  $\mu_d$  are farther apart), the inside contract in (6) is steeper and so the sum of the risk premiums in (9) is larger. When the parties become more risk averse, so  $a_p + a_d$  rises, there are two offsetting effects. First, holding the slope of the inside contract  $s_1$  fixed, the sum of the risk premiums increases. Second, the inside contract in (6) becomes flatter, and so the sum of the risk premiums falls. In equilibrium, this latter effect dominates.<sup>40</sup>

Evaluating the parties' payoffs with a single set of true beliefs, the social value of a trial with the inside contract is:

$$S^*(\mu_p, \mu_d, a_p, a_d, \sigma^2) = -R^*(\mu_p, \mu_d, a_p, a_d, \sigma^2) - (c_p + c_d). \quad (10)$$

□ **Outside Contracts.** We now assume that the plaintiff and the defendant may enter into bilateral contracts with third-party investors (instead of with each other). As described earlier, we assume that the capital market has many identical risk-neutral investors who share the belief that the outcome at trial is normally distributed with mean  $\mu_0$  and variance  $\sigma^2$ .<sup>41</sup> These investors compete with each other head-to-head for the opportunity to provide financial backing to the plaintiff and the defendant. The competitive market price of the lawsuit is  $\mu_0$ , and the investors break even in expectation.<sup>42</sup>

One might imagine that our setting would give rise to a proverbial “money pump” or “Dutch bookie” who could make unlimited profits by brokering trades between the two parties.<sup>43</sup> There are two reasons why this does not happen in our setting. First, strict convexity of preferences (e.g., risk aversion) will limit the gains that could be obtained by a bookie (Morris, 1995). This underscores the importance of risk aversion for our analysis. Second, we assume that third-party investors are competitive; any value created through a money pump would be captured by the plaintiff and the defendant themselves rather than by the bookie. As we discuss later, our core results are robust to alternative assumptions regarding market power.

We let  $t(x)$  denote the contract between the plaintiff and the financial service provider, who may be a litigation funder or other third party. With this contract,

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<sup>40</sup>The cost of risk is discontinuous. If  $a_p = a_d = 0$ , then  $R^*(\cdot) = 0$ . If  $a_p + a_d \rightarrow 0$ , the parties engage in increasingly large bets and  $R^*(\cdot) \rightarrow \infty$ . If there were exogenous limits on speculative contracting, then  $R^*(\cdot)$  would not diverge as  $a_p + a_d \rightarrow 0$ .

<sup>41</sup>Although we place no restrictions on these beliefs, it may in fact be the case that investors have unbiased beliefs,  $\mu_0 = \mu_t$ , and that the plaintiff and the defendant are more optimistic about their cases than the outside investors,  $\mu_d \leq \mu_0 \leq \mu_p$ .

<sup>42</sup>Since the outside investors share the same beliefs  $\mu_0$  they do not want to speculate with each other on the outcome of the litigation.

<sup>43</sup>For a discussion of the “money pump” in environments with non-common priors, see Binmore (1992) and Daughety and Reinganum (2012).

the plaintiff receives  $t(x) - c_p$  and the third party receives the residual amount  $x - t(x)$ . So, for example, if  $t(x) = 100 + x/4$ , then the investor is paying the plaintiff one hundred dollars for a seventy-five percent stake in the award. Similarly, we let  $r(x)$  represent the contract between the defendant and the financial service provider. With this contract, the defendant is responsible for paying  $r(x) + c_d$  and the third party pays the residual  $x - r(x)$ . Although this framework assumes that the plaintiff and the defendant are the ones to bear the litigation costs,  $c_p$  and  $c_d$ , this assumption is without loss of generality. Note also that because  $r(x)$  and  $t(x)$  need not equal each other, these third-party contracts allow the plaintiff and the defendant to decouple their respective interests. Decoupling will allow the parties to fine-tune their respective outside contracts to reflect their subjective risk preferences and beliefs.

For concreteness, we assume the following timing. In the first stage, the two parties have the opportunity to settle with each other. If their negotiations fail, then in the second stage the parties turn to the outside capital market and buy and/or sell claims on their respective positions. As in the previous section, we characterize the (subjective) Pareto-optimal contracts between the parties and their respective third-party investors. In the third stage, the court announces the award,  $x$ , and all financial claims are settled.

With this timing, we are obviously – and very decidedly – abstracting away from any conflicts of interest between the parties and their respective investors over whether to settle the case, and from any possible commitment value of third-party contracting.<sup>44</sup> This particular timing is not critical for the results, however. We could assume equivalently that the plaintiff and the defendant can sign contracts with third parties prior to settlement negotiations, so long as the parties and their backers can subsequently *renegotiate* their contracts if settlement negotiations fail.<sup>45</sup> So long as the parties and their respective investors negotiate settlements that are in their mutual interest, and can negotiate deals on the eve of trial that maximize their joint subjective value from trial, our results will hold.

It is instructive to begin the analysis by developing some general insights. Suppose the plaintiff can contract with a third-party investor who is risk averse with CARA coefficient  $a_0 > 0$  and beliefs  $f_0(x)$ . Using the earlier methodology, any equilibrium contract  $t(x)$  between the plaintiff and the third-party investor

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<sup>44</sup>There is an active literature exploring how contracts with third parties can be a valuable strategic commitment in litigation. Spier (2007) surveys this literature, which includes analyses of contingent-fee lawyers, insurance companies, and debtholders.

<sup>45</sup>In practice, the plaintiff may receive payments from investors before trial. If the case settles, the investor receives a share of the settlement. Note that agency problems could arise if the interests of the plaintiff and the investor diverge. This does not happen in the current setting.

will be of the form:

$$t(x) = t + \left( \frac{1}{a_p + a_0} \right) \ln \left( \frac{f_p(x)}{f_0(x)} \right) + \left( \frac{a_0}{a_p + a_0} \right) x \quad (11)$$

where  $t$  is a lump-sum payment.

It is interesting to compare expression (11) to our earlier expression (5), which characterized the equilibrium inside contract between the plaintiff and the defendant. The two contracts are similar, but there is an additional risk-sharing term in (11). Suppose that the third-party investor has the same beliefs and risk tolerance as the defendant, so  $f_0(x) = f_d(x)$  and  $a_0 = a_d$ , then the outside contract in (11) would have a larger slope than the analogous inside contract in (5). Intuitively, reducing the slope of  $s(x)$  in (5) reduces the risk *for both the plaintiff and the defendant*. In contrast, reducing the slope of  $t(x)$  in (11) shifts risk *towards the third-party investor*. So, the outside contract  $t(x)$  would expose the plaintiff to greater risk than the inside contract  $s(x)$ .

Now suppose that the third-party investors have normally-distributed beliefs with mean  $\mu_0$  and variance  $\sigma^2$  and are risk neutral ( $a_0 = 0$ ). The investors value the lawsuit at its expected value,  $\mu_0$ . In the competitive equilibrium, the outside investors compete to provide financial services to the plaintiff and defendant. The competitive market price is  $\mu_0$  and the investors break even in expectation.

As proven in the Appendix, the plaintiff's equilibrium outside contract is

$$t(x) = t_0 + t_1 x \quad \text{where} \quad t_0 = (1 - t_1)\mu_0 \quad \text{and} \quad t_1 = \frac{\mu_p - \mu_0}{a_p \sigma^2}. \quad (12)$$

This equilibrium contract makes intuitive sense. Suppose that the plaintiff and the third-party investors hold exactly the same beliefs, so  $\mu_0 = \mu_p$ . In this case, equation (12) tells us that  $t_1 = 0$ . In other words, the risk-averse plaintiff sells one hundred percent of the case to the risk-neutral investors for the competitive market price,  $t_0 = \mu_0$ . Suppose instead that  $\mu_0 < \mu_p$ , so the third-party investors think the case is weaker than the plaintiff believes it to be. Then, the plaintiff chooses to keep fraction  $t_1 > 0$  of the case and sells the residual stake to the investors for the competitive market price,  $t_0 = (1 - t_1)\mu_0$ .<sup>46</sup> Finally, comparing (12) to the optimal inside contract in (6) reveals that if  $\mu_0 = \mu_d < \mu_p$  then  $t_1 > s_1$ . If the capital market holds the same beliefs as the defendant, the optimal outside contract exposes the plaintiff to more risk than the optimal inside contract.

The defendant's equilibrium outside contract with their third-party backer has a similar form:

$$r(x) = r_0 + r_1 x \quad \text{where} \quad r_0 = (1 - r_1)\mu_0 \quad \text{and} \quad r_1 = \frac{\mu_0 - \mu_d}{a_d \sigma^2}. \quad (13)$$

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<sup>46</sup>If  $\mu_p$  is much larger than  $\mu_0$ , or if the plaintiff is not very risk averse, then  $t_1 > 1$  and  $t_0 < 0$ .

With this contract, the defendant is paying third-party investors a lump sum  $r_0 = (1 - r_1)\mu_0$  to accept responsibility for a fraction  $1 - r_1$  of the court award. Because the market price is  $\mu_0$ , the outside investors (just) break even on their investments. Note that if  $\mu_d = \mu_0$ , and so the defendant and the capital market share the same beliefs, then  $r_1 = 0$  in equation (13). In other words, the defendant would pay a price of  $r_0 = \mu_0$  to insure one hundred percent of the court award.

We now evaluate the decision of the parties to settle their case out of court. If the parties' settlement negotiations fail, they will enter into contracts with third-party investors as outlined in (12) and (13) above and will go to trial. Using our earlier methods, it is not hard to construct the bargaining range. The plaintiff's certainty equivalent of going to trial with the third-party contract  $t(x)$  is  $\underline{s} = (1 - t_1)\mu_0 + t_1\mu_p - a_pt_1^2\sigma^2/2 - c_p$ . Notice that this certainty equivalent is subjective, and is evaluated according to the plaintiff's subjective beliefs,  $\mu_p$ . This is the very least that the plaintiff would accept in settlement. Similarly, the defendant's (subjective) certainty equivalent is  $\bar{s} = (1 - r_1)\mu_0 + r_1\mu_d + a_dr_1^2\sigma^2/2 + c_d$ , which is the most that the defendant would be willing to pay to settle the case before trial. Combining these two expressions,  $\underline{s} > \bar{s}$  if and only if

$$c_p + c_d < (\mu_p - \mu_0)t_1 - a_pt_1^2\sigma^2/2 + (\mu_0 - \mu_d)r_1 - a_dr_1^2\sigma^2/2. \quad (14)$$

Using the slopes  $t_1$  and  $r_1$  from (12) and (13) above, we conclude that the parties will go to trial if and only if the costs of litigation are smaller than the parties' joint subjective benefits from trial,

$$c_p + c_d < B^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) = \frac{(\mu_p - \mu_0)^2}{2a_p\sigma^2} + \frac{(\mu_0 - \mu_d)^2}{2a_d\sigma^2}. \quad (15)$$

Because the third-party investors are breaking even in expectation, the right-hand side is also the joint subjective benefit of trial for all four parties.

It is straightforward to compute the aggregate cost of risk and social welfare. Because the third-party investors are risk neutral, we need only consider the risk premiums of the litigants,

$$R^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) = a_pt_1^2(\sigma^2/2) + a_dr_1^2(\sigma^2/2) = \frac{(\mu_p - \mu_0)^2}{2a_p\sigma^2} + \frac{(\mu_0 - \mu_d)^2}{2a_d\sigma^2}. \quad (16)$$

Evaluating the parties' payoffs with a set of objective beliefs, the social value of a trial with outside contracts is

$$S^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) = -R^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) - (c_p + c_d). \quad (17)$$

□ **Discussion.** Our model has important implications in real-world settings, and may be extended in a variety of ways.



*Coexistence of Inside and Outside Contracting.* We have assumed that the litigants either write inside contracts with each other or outside contracts with third-party investors. We have not explored the possibility that the parties may use both types of contracts, sharing risk with each other in addition to risk sharing with the external capital market. In the Appendix, we state and prove that if both the plaintiff and the defendant write the (subjectively) optimal contracts with the third parties in (12) and (13), then there is no additional value to be captured with inside contracts. Intuitively, gains from trade fail to exist because the plaintiff and defendant have exactly the same opportunity cost of funds.<sup>47</sup> The plaintiff would be delighted to sell some additional insurance to the defendant if the defendant was willing to pay more than  $\mu_0$  (which is the price paid by the litigation funder). But the defendant has no interest in paying this inflated price because he can already purchase as much insurance as he wants from the capital market at price  $\mu_0$ .

*Unequal Access to Capital.* Our previous analysis assumed that the litigants had equal access to the outside capital market. But in practice, litigation funding for plaintiffs is more common than after-the-event insurance for defendants. Perhaps surprisingly, the parties can and will obtain the very same joint benefits when only the plaintiff can access the capital market as when they both can access it. To see why this is true, note that the plaintiff and the defendant can write an inside contract that mimics the optimal outside insurance policy in (13),  $r(x) = r_0 + r_1x$  where  $r_0 = (1 - r_1)\mu_0$ . The plaintiff could then supplement this inside contract by selling a fraction  $r_1 - t_1$  of the case to an outside litigation funder for the market price  $(r_1 - t_1)\mu_0$ .<sup>48</sup> Similarly, if only the defendant could access the market, the defendant could purchase a stake in the plaintiff's case with an inside contract and acquire additional insurance (if necessary) from the capital market with an outside contract. Thus, even when only one party can access to the capital market, the parties can perfectly replicate  $r(x) = r_0 + r_1x$  and  $t(x) = t_0 + t_1x$  just as before.<sup>49</sup>

*Investor Market Power.* Our qualitative results would continue to hold if the third-party investors have market power. To see why, suppose that a third-party

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<sup>47</sup>If investors are risk averse and cannot diversify, the litigants would share risk with each other in addition to their respective funders. Cases with inside contracts often include insurance companies/contingent-fee lawyers. See Prescott et al. (2014) and Prescott and Spier (2016).

<sup>48</sup>Equivalently, the plaintiff can be an insurance middleman, purchasing the policy  $r(x) = r_0 + r_1x$  from the capital market and then reselling it to the defendant. The plaintiff would then sell a fraction  $1 - t_1$  of the case to a litigation funder with the contract  $t(x) = t_0 + t_1x$ .

<sup>49</sup>Note that a party who lacks direct access to the capital market would be at a bargaining disadvantage. If the defendant lacks access, the plaintiff could charge more than  $r_0$  for the insurance policy. In the text, we maintain the original market price  $r_0$  for illustrative ease.

investor could make a take-it-or-leave-it contract offer to the plaintiff before trial. The equilibrium contract offer would be Pareto-optimal, and would necessarily satisfy the condition in equation (11).<sup>50</sup> Although the lump-sum payment would be lower than it was before (because the third party investor can capture rents), the slope of the contract would be exactly the same as in equation (12).<sup>51</sup> Similarly, if a third party had some market power over the defendant, he could demand a higher lump-sum payment than  $r_0 = (1 - r_1)\mu_0$ . However, the slope of the contract  $r_1$  would not depend on the allocation of bargaining power. Thus, the slopes of the outside contracts  $r_1$  and  $t_1$ , and the aggregate cost of risk, do not depend on the competitiveness of the capital market.

*Negative Expected Value Claims.* Our earlier analysis assumed that the plaintiff always had a credible threat to litigate. That is, we assumed that the plaintiff's subjective payoff from a naked trial was non-negative,  $\mu_p - a_p\sigma^2/2 - c_p \geq 0$ . So, if negotiations broke down, the plaintiff would not want to drop the case. If instead the plaintiff's case had negative expected value, then the plaintiff could not credibly threaten the defendant to go to trial. The defendant, knowing that the plaintiff's case is not viable and would be dropped, could simply refuse to participate in contract negotiations.<sup>52</sup> With outside contracts, the plaintiff has a stronger threat to go to trial. If negotiations with the defendant break down, the plaintiff can turn to the capital market, boosting the plaintiff's subjective value from litigation. The plaintiff-litigation funder team would have a credible threat to go to trial when  $(1 - t_1)\mu_0 + t_1\mu_p - a_p t_1^2 \sigma^2 / 2 - c_p \geq 0$ . Because litigation funding improves the plaintiff's outside option, it strengthens the plaintiff's threat to go to trial and benefits the plaintiff (in a subjective sense) at the expense of the defendant.

*Endogenous Litigation Spending.* In the model, the costs of litigation were exogenous and did not depend on the inside or outside contracts signed. In practice, these contracts could change the equilibrium incentives of the parties to invest in litigation. One can easily extend the model to consider litigation as a rent-seeking contest where, by spending additional money in preparation for trial, a party can

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<sup>50</sup>We assume that outside contracts are negotiated on a case-by-case basis. If outside investors had to offer the same contract terms to all litigants, then monopoly distortions could arise.

<sup>51</sup>The insight that market power would not change the slope of the contract is also evident from our general characterization of inside contracts in (6). All Pareto-optimal contracts share the same slope.

<sup>52</sup>Inside contracting may still arise when  $\mu_p$  is much larger than  $\mu_d$  so that the slope is greater than one. In this case, the lump-sum payment is negative and the plaintiff pays the defendant to go to trial as before.

move a factfinder's decision in his or her favor.<sup>53</sup> Inside contracts that mitigate the risk of trial would also curb the parties' incentives to spend money litigating the suit.<sup>54</sup> This private and social benefit may be foregone when the parties contract instead with third-party investors. Intuitively, the plaintiff-investor team shares the unmitigated damage award, and defendant-investor team bears the corresponding unmitigated loss. Because each team faces the full exposure of a trial, they would have no joint incentive to curb their spending.<sup>55</sup>

*Wealth Constraints.* In our analysis, neither the plaintiff nor the defendant were wealth constrained. The plaintiff had adequate funds to pay for the cost of litigation  $c_p$  and the defendant had adequate resources to pay for the litigation costs  $c_d$  and any damage award  $x$ , and we placed no restriction on the lump-sum transfer payments in their inside and outside contracts. These assumptions may be appropriate in some circumstances, such as in settings involving well-heeled companies and commercial litigation. In settings where plaintiffs and their lawyers are liquidity constrained, better access to litigation funding and other outside contracts may be instrumental for giving plaintiffs greater access to the legal system. Without outside capital, plaintiffs may simply be unable to proceed to trial and defendants, knowing this, would refuse to settle.<sup>56</sup>

*High-Low Agreements.* In actual litigation practice, one observes partial settlement agreements with a variety of functional forms. Although some of these agreements are linear, others are not.<sup>57</sup> One relatively common contingent settlement contract is the high-low agreement, where the ultimate payout is constrained by a floor and a ceiling (Prescott et al., 2014; Prescott and Spier, 2016).<sup>58</sup>

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<sup>53</sup>See the Online Appendix and Prescott et al. (2014) for formal models. See Konrad (2009) for a survey of the contest literature. Applications to litigation include Posner (1973, appendix), Katz (1988), and Rosenberg and Spier (2014).

<sup>54</sup>When designing their inside contract, the parties have a joint incentive to make it flatter (relative to what they would do with exogenous litigation costs) as a commitment to not engage in future wasteful rent seeking.

<sup>55</sup>This argument is premised on the assumption that there is Coasian bargaining between a litigant and his/her financial service provider, but not between the two litigants. See the Online Appendix for details and discussion.

<sup>56</sup>A potentially insolvent defendant may have less incentive to purchase a generous insurance policy because the premiums would be high and the benefit of generous insurance may largely accrue to the plaintiff.

<sup>57</sup>In 2010, SAP paid Oracle \$120 million in exchange for Oracle agreeing not to seek punitive damages. In *Palimere v. Supermarkets* in footnote 2, the parties agreed to a 75%/25% split of damages. See Prescott and Spier (2016) for these and additional examples.

<sup>58</sup>With a high-low agreement, the plaintiff has the option to sell the claim for the floor value (put option), and the defendant has the option to buy the claim for the ceiling value (call option). See footnote 3.

It is not difficult to construct subjective beliefs and preferences that generate high-low agreements in equilibrium (or contracts that are “close” to high-low agreements). First, high-low agreements are often optimal when the parties’ subjective beliefs are binary on a common support. For example, the parties may share common beliefs about the level of damages, but fundamentally disagree about the probability that the plaintiff will win. Moderately risk-averse parties would use a high-low contract to pull the binary outcomes (“win” and “lose”) closer together.<sup>59</sup> Second, one can modify normally-distributed beliefs in a way that is fully consistent with high-low agreements. Technically, one could change the shape of the tails so that the likelihood ratios in the tail regions are constant.<sup>60</sup> Finally, with triangular distributions with different modes and CARA preferences, one can get contracts that are remarkably similar to high-low contracts.<sup>61</sup>

That said, the popularity of high-low agreements in litigation practice is probably due more to their simplicity and intuitive appeal than to their analytical purity. In practice, it is not uncommon for the “high” and the “low” values to be the plaintiff’s and defendant’s last and final settlement offers before reaching a bargaining impasse. In the examples given above, generating a slope of exactly one,  $s'(x) \equiv 1$ , in some middle region requires a knife-edged configuration of parameter values.<sup>62</sup> Although high-low agreements may not be Pareto optimal, they can avoid extreme outcomes and thus accomplish the risk-sharing benefits of more elaborate and sophisticated schemes.

### 3 Welfare Analysis

■ We now compare the three contractual regimes – naked trials, inside contracts, and outside contracts – in terms of their subjective value to the litigants and their costs to society.

Before we begin, it is helpful to define a piece of new notation. Let  $\hat{\mu}_0$  be the following weighted average of the plaintiff’s and the defendant’s subjective

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<sup>59</sup>See Prescott et al. (2014).

<sup>60</sup>Consider a bounded support that is divided into three regions. Suppose that the beliefs follow the normal curves in the middle region, but have modified tails with constant likelihood ratios  $f_p(x)/f_d(x)$  in the bottom and top regions (uniform or linear beliefs suffice).

<sup>61</sup>Suppose  $f_p(x)$  and  $f_d(x)$  are triangular and defined on  $[20, 120]$  (in thousands) with mode values 40 and 100. The ratio  $f_p(x)/f_d(x)$  is constant when  $x < 40$  or  $x > 100$ , creating a floor and ceiling. If  $a_p + a_d = .00002$ , the slope for  $x \in [40, 100]$  is approximately one.

<sup>62</sup>If  $\mu_p = 90, \mu_d = 50, \sigma = 20$  and  $a_p + a_d = .0002$ , the inside contract has a slope of  $s_1 = .50$ . If  $a_p + a_d = .0001$  instead, then the slope is unity. See the Online Appendix for further details.

beliefs,  $\mu_p$  and  $\mu_d$ :

$$\hat{\mu}_0 = \frac{a_d \mu_p + a_p \mu_d}{a_p + a_d}. \quad (18)$$

When the beliefs of the external capital market coincide with this threshold, so  $\mu_0 = \hat{\mu}_0$ , then slopes of the inside contract  $s(x)$  and the slopes of the outside contracts  $t(x)$  and  $r(x)$  are all exactly the same.

The fact that there exists a threshold  $\hat{\mu}_0$  where the slopes of the three contracts coincide is intuitive. The inside contract  $s(x) = s_0 + s_1 x$  in equation (6) creates a Pareto-optimal allocation of risk for the plaintiff and defendant (from a subjective perspective). By the second fundamental theorem of welfare economics, this allocation can be supported as a competitive equilibrium. If the price of the lawsuit were fixed at  $\hat{\mu}_0$  defined in (18), the plaintiff would choose to keep fraction  $s_1$  of the lawsuit and sell the residual fraction. Similarly, the defendant would choose to retain fraction  $s_1$  of the risk and purchase insurance for the residual fraction. So, when the market price of the lawsuit is  $\hat{\mu}_0$ , then the slopes of the inside and outside contracts coincide:  $r_1 = s_1 = t_1$ .

**LEMMA 1:** *If  $\mu_0 = \hat{\mu}_0$  then  $r_1 = s_1 = t_1$ , if  $\mu_0 < \hat{\mu}_0$  then  $r_1 < s_1 < t_1$ , and if  $\mu_0 > \hat{\mu}_0$  then  $r_1 > s_1 > t_1$  where  $r_1$ ,  $s_1$ , and  $t_1$  are defined in (6), (12), and (13).*

Figure 1 shows how the slopes of the three contracts depend on the competitive market price  $\mu_0$  for the case where  $\mu_d < \mu_p$ . If the capital market has the same beliefs as the defendant, so  $\mu_0 = \mu_d$ , then the defendant insures the entire loss at trial ( $r_1 = 0$ ) and the plaintiff sells part (but less than one hundred percent) of the case to litigation funders ( $t_1 > 0$ ). As the outside market price  $\mu_0$  rises, two things happen: the defendant purchases less insurance ( $r_1$  rises) and the plaintiff seeks more litigation funding ( $t_1$  falls). At the other end of the spectrum, when  $\mu_0 = \mu_p$ , the plaintiff sells the entire lawsuit to third-party investors ( $t_1 = 0$ ) for a competitive price  $\mu_0$  and the defendant purchases partial insurance ( $r_1 > 0$ ). When  $\mu_0 = \hat{\mu}_0$ , the stake sold by the plaintiff is equal to the insurance demanded by the defendant and  $r_1 = s_1 = t_1$ .

\*\*\*INSERT FIGURE 1 AT TOP OF PAGE ABOUT HERE\*\*\*

□ **The Subjective Benefits of Litigation.** We now compare the parties' joint subjective value in the three contractual regimes – naked trials, inside contracts, and outside contracts.

First, and most obviously, the parties are subjectively better off with inside contracts than with naked trials. This follows from revealed preference. More interestingly, the plaintiff and defendant are weakly better off (in a joint subjective

sense) when they can transact with the outside capital market. With inside contracts, the fortunes of the plaintiff and defendant are inextricably tied together. In contrast, the outside market affords the litigants the flexibility to fine-tune their stakes to better suit their subjective beliefs and risk preferences.<sup>63</sup> Through the outside market, the plaintiff and defendant can decouple their financial interests, and this works to their mutual advantage.

To see these results formally, compare the subjective joint benefit of litigation from the outside contracts  $B^0(\cdot)$  given in equation (15) to the subjective joint benefit of the inside contract  $B^*(\cdot)$  given in equation (8). Using the definition of  $\hat{\mu}_0$  in (18), one can show that

$$B^0(\cdot) = B^*(\cdot) + \left( \frac{a_p + a_d}{2a_p a_d \sigma^2} \right) (\mu_0 - \hat{\mu}_0)^2. \quad (19)$$

Because  $(\mu_0 - \hat{\mu}_0)^2 \geq 0$ , we have  $B^0(\cdot) \geq B^*(\cdot)$ . The plaintiff and defendant are weakly better off with outside contracting than with inside contracting. Next, comparing the subjective joint benefit of the inside contract represented in equation (7) to the joint benefit of the naked trial  $B^N(\cdot)$  in (1), we find that

$$B^*(\cdot) = B^N(\cdot) + \frac{(a_p + a_d)\sigma^2}{2} (1 - s_1)^2. \quad (20)$$

The inside contract creates more value than the naked trial when the slope of the inside contract  $s_1 \neq 1$ . We have the following result.

**PROPOSITION 1:** *The joint subjective value of litigation is lowest when all contingent contracts are prohibited, weakly higher when only inside contracts between the parties to the dispute are permitted, and weakly higher still when parties are free to write contracts with the outside capital market,  $B^N(\cdot) \leq B^*(\cdot) \leq B^0(\cdot)$ . Inside and outside contracts create the same joint subjective value if and only if the capital market's beliefs are  $\mu_0 = \hat{\mu}_0$  defined in (18). Inside contracts and naked trials create the same joint subjective value if and only if the inside contract in (6) has a slope of one,  $s_1 = 1$ .*

When the capital market's beliefs are a properly weighted average of the litigants' beliefs,  $\mu_0 = \hat{\mu}_0$ , then the parties do just as well contracting with each other as they do contracting with third parties,  $B^*(\cdot) = B^0(\cdot)$ . In other words, there is a measure zero set of parameter values that eliminates the value of trading

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<sup>63</sup>By Lemma 1, if  $\mu_0 < \hat{\mu}_0$  then  $r_1 < s_1 < t_1$ . With outside contracts, the defendant chooses to insure a higher fractional stake of the case than the plaintiff chooses to sell.

with outside investors.<sup>64</sup> This follows from the fact that when  $\mu_0 = \hat{\mu}_0$ , the slopes of all three contracts are the same,  $r_1 = s_1 = t_1$  (Lemma 1). Given the market price  $\hat{\mu}_0$ , the plaintiff would choose to sell a fraction  $1 - s_1$  of the lawsuit to a litigation funder for a lump-sum payment  $(1 - s_1)\hat{\mu}_0$ , and the defendant would pay investors  $(1 - s_1)\hat{\mu}_0$  to insure a fraction  $1 - s_1$  of their future loss. In this knife-edged case, the plaintiff and the defendant do not need the outside capital market. They can achieve the very same subjective benefits by contracting with each other and cutting out the middlemen.

This result is perhaps all the more surprising because by design we have stacked the deck in favor of third-party investors by assuming that they are risk neutral, competitive, and transaction-cost free. If there were any transactions costs of dealing with outside suppliers of capital (costs of negotiating contracts, agency, or due diligence), then there will be a range of parameter values where the parties are better off forgoing the external capital market. In other words, in practice the defendant may be in a better position than the market to supply funding to the plaintiff, and the plaintiff may be in a better position than the market to supply insurance to the defendant.

Although the plaintiff and the defendant are subjectively better off in a joint sense when outside capital markets are available, it does not necessarily follow that the plaintiff and defendant are better off *individually*. Whether an individual litigant is better off or worse off will depend on the beliefs of the capital market,  $\mu_0$ , how risk averse they are, and the bargaining power of the litigants when negotiating the inside contract,  $\pi$  and  $1 - \pi$ . The next proposition provides a partial ranking of the individual subjective benefits of outside versus inside contracting. In the proposition, the bargaining power threshold  $\hat{\pi}$  depends on the risk aversion of the two parties and is defined as follows:

$$\hat{\pi} = \frac{a_d}{a_p + a_d}. \quad (21)$$

**PROPOSITION 2:** *Suppose  $\mu_0 = \hat{\mu}_0$ . The defendant is better off (worse off) and the plaintiff is worse off (better off) with the outside contract than with the inside contract if the defendant's bargaining power is low (high),  $\pi < \hat{\pi}$  ( $\pi > \hat{\pi}$ ). Suppose  $\pi = \hat{\pi}$ . The defendant is better off (worse off) and the plaintiff is worse off (better off) with the outside contract than with the inside contract when the capital market believes that the damages are low (high),  $\mu_p - a_p\sigma^2 < \mu_0 < \hat{\mu}_0$  ( $\hat{\mu}_0 < \mu_0 < \mu_d + a_d\sigma^2$ ).*

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<sup>64</sup>If  $\mu_p = \mu_d$ , then the inside contract would have a slope of zero – the plaintiff and defendant would face no risk. If  $\mu_0 = \hat{\mu}_0 = \mu_p = \mu_d$ , then outside investors would purchase one hundred percent of the plaintiff's case and insure one hundred percent of the defendant's case.

Intuitively, the plaintiff will benefit from selling an equity stake to the outside capital market if the price that the outside market will pay is higher than the inside price (the price that the plaintiff would otherwise negotiate with the defendant). The outside market price will tend to be high when the capital market believes that the expected damages are high,  $\mu_0 > \hat{\mu}_0$ . The inside contract price will tend to be low when the plaintiff's bargaining power is low ( $\pi$  is high). On the flip side, the defendant would benefit from purchasing insurance from the outside market if the price of that insurance is lower than the inside contract price. Thus, the defendant will tend to be better off with the outside contract when the market price  $\mu_0$  is low and when the defendant's bargaining position is weak ( $\pi$  is low). Finally, note that if the plaintiff is much more averse to risk than the defendant then the plaintiff will be in a very bad bargaining position when negotiating an inside contract with the defendant. Formally, when the plaintiff is very risk averse, then  $\hat{\pi}$  in (21) is very small. In this case, the plaintiff is likely to obtain significant benefits from access to the outside capital market.

□ **The Social Costs of Litigation.** We begin by ranking the regimes according to the costs of litigation, or equivalently the litigation rate. Recall that the parties will choose to go to trial when the sum of their litigation costs,  $c_p + c_d$ , is smaller than the joint subjective benefit of litigation. Because the parties' joint subjective benefits of litigation are ranked in Proposition 1,  $B^N(\cdot) \leq B^*(\cdot) \leq B^0(\cdot)$ , we have the following result.

**PROPOSITION 3:** *The litigation rate (and litigation costs) are lowest when all contingent contracts are prohibited, weakly higher when only inside contracts between the parties to the dispute are permitted, and weakly higher still when parties are free to write contracts with the outside capital market.*

This result is not surprising. By revealed preference, parties enter into contracts for the very purpose of making trial more attractive by mitigating risk and/or capturing benefits of mutual speculation. So, when compared with a world where contracting on the trial outcome is impossible or prohibited, contingent contracts will tend to discourage settlement and stimulate litigation. Although we do not have direct empirical proof that inside contracts will increase the rate of litigation in practice, the experience of New York's Summary Jury Trial Program is suggestive. In a data set of more than 2,700 lawsuits that entered this program, more than eighty percent included high-low contracts (Prescott and Spier, 2016). Furthermore, the cases with high-low agreements were significantly less likely to settle out of court.<sup>65</sup>

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<sup>65</sup>One cannot attribute this pattern to causation, of course. Cases that are unlikely to settle have a greater need for high-low agreements.



We will now rank the three contractual regimes according to their aggregate litigation risks. Comparing the risks  $R^*(\cdot)$  from the inside contract in (9) to the risk  $R^N(\cdot)$  from the naked trial in (2) we have:

$$R^*(\cdot) = R^N(\cdot)s_1^2 \quad (22)$$

where  $s_1$  is the slope of the equilibrium inside contract (6). Compared with a naked trial, the inside contract may either raise or lower the sum of the risk premiums, depending on whether the contract mitigates the risk (the slope  $s_1^2 < 1$ ) or amplifies the risk ( $s_1^2 > 1$ ). Next, comparing  $R^*(\cdot)$  to the risks from the outside contract  $R^0(\cdot)$  in (16) and using the definition of  $\hat{\mu}_0$  in (18), we show in the Appendix that:

$$R^0(\cdot) = R^*(\cdot) + \left( \frac{a_p + a_d}{2a_p a_d \sigma^2} \right) (\mu_0 - \hat{\mu}_0)^2. \quad (23)$$

When the capital market's beliefs satisfy  $\mu_0 = \hat{\mu}_0$ , then outside contracts and inside contracts create the same level of risk. This follows from our earlier result that  $r_1 = s_1 = t_1$ . More strikingly, equation (23) tells us that outside contracts have a strictly higher costs of risk bearing whenever  $\mu_0 \neq \hat{\mu}_0$ . If  $\mu_0 < \hat{\mu}_0$ , for example, then  $r_1 < s_1 < t_1$ . In this case, the outside contract exposes the defendant to less risk and exposes the plaintiff to more risk than the inside contract. But taken together, the sum of the risk premiums is necessarily higher.<sup>66</sup> Thus, under the assumptions of the model, allowing the parties to the dispute to write contracts with risk-neutral competitive investors will never lower the amount of aggregate risk that they face, and will generally increase it.

**PROPOSITION 4:** *The aggregate costs of risk bearing are smaller with inside contracts than naked trials when the inside contracts mitigate risk ( $s_1^2 < 1$ ) and are larger when the inside contracts amplify the risk ( $s_1^2 > 1$ ). Outside contracts with third-party suppliers of capital may create more aggregate risk than inside contracts,  $R^0(\cdot) \geq R^*(\cdot)$ .*

The result that outside contracts may actually raise the aggregate cost of risk-bearing (relative to inside contracts) is interesting. Recall that contracts create subjective value in two ways: risk allocation and speculation. Intuitively, parties who are limited to inside contracts have a joint subjective interest in supplying each other with additional insurance and forgoing some subjective benefits of speculation. The availability of risk neutral third-party investors gives the parties more degrees of freedom and greater opportunities for mutual speculation,

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<sup>66</sup>Conversely, if  $\mu_0 > \hat{\mu}_0$ , then the outside contract exposes the plaintiff to less risk and the defendant to more risk but the sum of the risk premiums still rise.

raising the overall risk level. This insight is aligned with recent findings in the behavioral finance literature where the introduction of new financial products increases market risk when traders have heterogeneous beliefs (Simsek, 2013; Weyl, 2007; Dieckmann, 2011).

Even though the parties may believe subjectively that contingent contracts are in their mutual interest at the time of contracting, they may be jointly worse off when their payoffs are evaluated using a single set of objective beliefs. Recall that we defined social welfare to be the sum of the certainty equivalents of all parties (the litigants and the outside investors), evaluated using a single set of objective beliefs rather than the parties' subjective beliefs. If the case goes to trial, then social welfare reflects the costs of risk bearing and the costs of litigation,

$$S^i(\cdot) = -R^i(\cdot) - (c_p + c_d). \quad (24)$$

When the parties' payoffs are evaluated with a single set of beliefs, the parties' subjective benefit of speculation disappears and all that remains are the trial risks,  $R^i(\cdot)$ , and the litigation costs,  $c_p + c_d$ .

**PROPOSITION 5:** *If the slope of the inside contract  $s_1$  satisfies  $s_1^2 < 1$  and the costs of litigation are not too large,  $c_p + c_d < B^N(\cdot)$ , then social welfare is strictly higher with the inside contract than with a naked trial,  $S^*(\cdot) > S^N(\cdot)$ . If  $c_p + c_d > B^N(\cdot)$  or  $s_1^2 > 1$  then social welfare is weakly lower with the inside contract than with a naked trial,  $S^*(\cdot) < S^N(\cdot)$ . Social welfare is weakly lower when the litigants can write outside contracts with third-party investors than when they can only write inside contracts with each other,  $S^0(\cdot) \leq S^*(\cdot)$ .*

According to Proposition 5, inside contracts may either raise or lower social welfare relative to a naked trial. If  $c_p + c_d < B^N(\cdot) \leq B^*(\cdot)$ , then the case will go to trial rather than settle in both the naked-trial and inside-contracting regimes. Because the litigation costs are the same in both regimes, any difference in social welfare would hinge on trial risks. If the slope of the inside contract is smaller than one,  $s_1^2 < 1$ , then the inside contract mitigates risk relative to a naked trial and increases social welfare. Conversely, if  $s_1^2 > 1$ , then the inside contract amplifies risk relative to a naked trial and reduces social welfare. If  $B^N(\cdot) < c_p + c_d \leq B^*(\cdot)$ , then the case will settle out of court in the naked-trial regime but will go to trial in the inside-contracting regime. In this case, inside contracting reduces social welfare.

Proposition 5 also implies that social welfare is lower when parties can write contracts with outside investors than when they are restricted to inside contracts. This is true for two reasons. First, cases are more likely to go to trial with outside contracts than inside contracts, raising the costs of litigation (Proposition 3).

Second, the aggregate cost of risk bearing is lower with inside contracts than with outside contracts (Proposition 4). In this sense, society would be better off prohibiting parties from entering into contracts with outside investors and forcing them to instead contract just with each other.

□ **Discussion.** Our welfare analysis focused exclusively on the subjective benefits of the litigants and the costs and aggregate risks of litigation. There are additional welfare concerns that are outside of our formal model but nonetheless important to keep in mind.

*The Defendant's Incentives for Care.* The anticipation of contingent contracting could of course influence the behavior of potential defendants ex ante, before lawsuits even arise. In the model, the litigants are better off ex post with contingent contracting. This follows from revealed preference, as the litigants enter into contingent contracts willingly.<sup>67</sup> If a potential defendant anticipates receiving positive benefits of future contingent contracting, then the party's incentives to take precautions to avoid harming the prospective plaintiff would be diluted. In this case, the potential defendant would take fewer precautions to avoid causing harm and there will be more accidents in equilibrium.<sup>68</sup>

The fact that litigants perceive themselves to be better off ex post with contingent contracting does not necessarily imply that litigants are subjectively better off ex ante. In many cases, individuals may share the same objective beliefs before accidents arise, but then fall victim to self-serving biases ex post, after they learn whether they are the victims (plaintiffs) or the injurers (defendants). Insofar as potential defendants anticipate succumbing to future self-serving bias, and consequently bearing larger costs if the plaintiff-to-be suffers harm, a potential defendant would have stronger incentives to take precautions to avoid accidents. In this scenario, there would be fewer accidents in equilibrium.

*The Plaintiff's Decision to Bring Suit.* The opportunity to turn to the capital market for outside funding could in practice affect the plaintiff's decision to file a lawsuit against the defendant. As discussed earlier, access to the outside capital market can turn what would otherwise have been a negative expected value case into a positive expected value one. If negotiations break down, then the capital market might share the risk or facilitate speculation, thus improving the plaintiff's

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<sup>67</sup>A similar argument applies to simple non-contingent settlements. See surveys by Spier (2007) and Daughety and Reinganum (2012) for a general discussion of the effects of litigation and settlement on deterrence, including the role of litigation costs.

<sup>68</sup>This would obviously be bad for social welfare if the defendant had been under-deterred to begin with, but could raise welfare if the defendant had been over-deterred. See Shavell (1997) on the divergence between the private and social incentive to litigate.

outside option.<sup>69</sup> The capital market can also make litigation feasible if the plaintiff is wealth constrained.

In these cases, access to litigation funding by the plaintiff will lead to more trials, and hence higher litigation costs and more aggregate risk, reinforcing our earlier results. Because litigation funding can turn a negative expected value case into one that is viable, this will also feed back into providing stronger incentives for the defendant to take precautions to avoid harming a potential plaintiff in the first place. This is socially valuable if the defendant was otherwise under-deterred. But if the negative expected value claim is one that has little social value (a largely frivolous case that will not improve the defendant's incentives for care), the availability of litigation funding would be socially harmful.

*Other Welfare Effects.* Although many of the costs of litigation are privately borne by the parties themselves, others are subsidized by taxpayers. The time costs of the judge, the foregone opportunities of jury members, and the costs of overhead and infrastructure are not fully paid for by the direct users of the court's services. Thus, the costs of litigation considered by the parties when crafting their settlement strategies may well understate the actual costs of increased litigation. Note also that lawsuits may in some circumstances create external benefits. One benefit is the development of case law, the stock of which may be viewed as a public good. Then, insofar as inside contracts stimulate additional litigation, they could increase the stock of this public good.<sup>70</sup>

*Aggregate Risk Bearing.* Under the assumptions of our model (risk-averse litigants, CARA preferences, normally-distributed beliefs, etc.), outside contracts with risk-neutral third-party investors create more aggregate risk than inside contracts. This result may be seen in a numerical example where  $\mu_p = 90$ ,  $\mu_d = 50$ ,  $\mu_0 = 80$  and  $\sigma = 20$ , all in thousands, and risk aversion coefficients  $a_p = a_d = .0001$  (see the Online Appendix). With this configuration of parameter values, the inside contract has a slope of  $s_1 = .50$ , so the plaintiff sells half of the case to the defendant (equivalently, the defendant buys insurance for half of the case from the plaintiff). With outside contracts, the plaintiff bears less risk ( $t_1 = .25$ ) and the defendant bears more risk ( $r_1 = .75$ ). The sum of the plaintiff's and defendant's risk premiums is higher with outside contracts than with inside contracts because  $(.25)^2 + (.75)^2 > (.50)^2 + (.50)^2$ .

The result that outside contracts lead to weakly higher costs of risk bearing, although interesting and provocative, was obtained under strong and stylized as-

<sup>69</sup>Note that a liquidity constrained plaintiff would benefit even more, as the outside capital market would make the lawsuit feasible.

<sup>70</sup>This would lead a more efficient allocation of resources and incentives for care. See Landes and Posner (1976) for an early theoretical and empirical analysis of precedent.

sumptions. In our model, both inside and outside contracts become steeper (more risky) when the parties become less risk averse. When  $a_p$  is very small, the plaintiff's outside contract with the capital market amplifies risk rather than reduces it. Indeed, as  $a_p$  approaches zero, the plaintiff's risk premium in (16) increases without bound.<sup>71</sup> If there were natural bounds on the ability of litigants to double down in this way, or legal constraints (anti-gambling statutes, for example), then the risk premiums would not increase without bound. Generalizing our model to include other preferences, belief structures, and liquidity constraints is beyond the scope of our article and is left as an avenue for further work.

## 4 Conclusion

■ In this article, two risk-averse parties with different subjective beliefs negotiate in the shadow of a pending trial. Through contingent settlement contracts, the parties may condition their future transfer payments on the trial outcome itself. Contingent settlement contracts are feasible, legal, and may offer significant private benefits relative to a full settlement or a “naked trial.” As the use of these contracts can make trial more attractive for the parties, these contracts will tend to increase the probability of litigation. Compared to a world where these contracts are not possible, risk could be lower or higher depending on whether the parties choose to mitigate trial risk or to amplify it. Access to a well-functioning capital market will (weakly) improve the subjective joint payoffs of the parties relative to what they could achieve on their own. However, under the assumptions of our model, access to the capital market increases litigation costs and the costs of risk bearing.

Strikingly, our analysis suggests parties to a dispute can themselves secure many of the risk-shifting benefits provided by third-party investors.<sup>72</sup> Recall that equilibrium inside contracts include a lump-sum payment from the defendant to the plaintiff coupled with a contingent payment (e.g., a fraction of the court's award). Through this contract, *the defendant is effectively playing the role of a litigation funder*, paying a lump-sum purchase price to the plaintiff in exchange for a stake in the plaintiff's claim. On the flip side, *the plaintiff is effectively playing the role of an insurer*. The lump-sum payment made by the defendant is analogous to an insurance premium. In return for this premium, the plaintiff-insurer bears a portion of the defendant's loss. Our theory suggests that parties

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<sup>71</sup>Similarly, as  $a_d$  approaches zero, the defendant's risk premium diverges. Note that there is a discontinuity: When the litigants are both risk neutral, there is no social cost associated with extreme gambling. We thank a referee for pointing this out.

<sup>72</sup>Bypassing the third-party investors can also reduce transactions costs.

are more likely to write creative contingent contracts with each other in settings where capital markets are imperfect and fail to operate efficiently.<sup>73</sup>

Although the primary focus of this article is litigation, our ideas may extend to other economic settings as well. Consider for example a small farmer who is planting a crop in advance of harvest, and a local food processor. The farmer and processor may choose to fix the sale price several months in advance of the harvest, eliminating the pricing risk, or sign a forward contract where the sale price is contingent on a benchmark provided by a reporting service (Paul et al., 1985). Alternatively, the farmer and processor might hedge their positions by contracting with third parties on a formal exchange. Through put and call options and other financial instruments, the farmer and processor can hedge risk and/or speculate on future commodity prices.<sup>74</sup> Our results imply that the aggregate risk borne in the vertical chain may actually be higher when the participants have access to the capital market and can actively trade in futures and options. The possible link between futures markets and price volatility has, historically, prompted disdain for speculators and discomfort with organized futures and options exchanges.<sup>75</sup>

Our model is premised on the idea that the parties involved in litigation – the plaintiff and the defendant – may hold different subjective beliefs about the outcome at trial. Importantly, our model assumes that the litigants are stubborn in their beliefs and do not revise or update them when confronted with the differing opinions of others (including the capital market). Although we believe that our theoretical approach is valuable and empirically relevant, we do not think that this is the only valuable approach. Future research might explore contracting in a dynamic environment that includes Bayesian learning and/or asymmetric information. For example, litigants’ beliefs may converge over time and through the discovery process as more details about the case come to light.<sup>76</sup> In addition, privately-informed parties may use their inside and outside contracts to signal the value of their claims to their opponents and the judge or jury.<sup>77</sup>

Finally, our work raises important policy questions. For example, should liti-

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<sup>73</sup>In the US, after-the-event insurance is rare. Note, however, that litigation funder Burford Capital has invested in defense-side deals (Molot, 2014). In England, where legal fees are shifted to the loser, litigation insurance policies are not uncommon (Molot 2009).

<sup>74</sup>For example, a farmer may buy one call option at a low strike price while simultaneously selling a second call option at a higher strike price. As with the high-low contract in litigation, this creates a floor and a ceiling for the farmer’s return.

<sup>75</sup>In 1958, the United States Congress passed Public Law 85-839, the “Onion Futures Act,” to prohibit onion futures trading because “speculative activity in the futures markets causes such severe and unwarranted fluctuations in the price of cash onions ...”

<sup>76</sup>Yildiz and Vasserman (2016) combine Bayesian learning with divergent beliefs.

<sup>77</sup>See Lavie and Tabbach (2017) for signaling with inside contracts and Avraham and Wickelgren (2014) for signaling with outside contracts.

gants be required to disclose their financial arrangements, both inside and outside, to courts? In practice, plaintiffs and defendants often hide their contingent settlement contracts (e.g., high-low agreements) from the judge and jury, out of an apparent concern that doing so could bias the court's judgment.<sup>78</sup> Litigation funding contracts are almost never disclosed, as plaintiffs and their attorneys are typically bound by nondisclosure agreements.<sup>79</sup> In response to this lack of transparency, three members of the U.S. Senate Judiciary Committee proposed the *Litigation Funding Transparency Act of 2018* which would require certain litigants to disclose the identity of "any commercial enterprise" that has a contingent financial interest in the outcome (settlement or judgment) of a case, and to produce the agreements "for inspection and copying." This is an exciting direction for future research.<sup>80</sup>

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<sup>78</sup>See Prescott and Spier (2016).

<sup>79</sup>Litigation funders view these contracts as proprietary. See Steinitz (2012).

<sup>80</sup>In his public statement, chairman Chuck Grassley (R-Iowa) says "for too long, obscure litigation funding agreements have secretly funneled money into our civil justice system, all for the purpose of profiting off someone else's case." See <https://www.grassley.senate.gov/news/news-releases/grassley-tillis-cornyn-introduce-bill-shine-light-third-party-litigation>.

## Appendix

**Proof of Equation (5):** Because  $u'_i(z) = a_i \exp(-a_i z)$ , we have

$$\frac{f_p(x)}{f_d(x)} \frac{a_p \exp[-a_p(s(x) - c_p)]}{a_d \exp[-a_d(-s(x) - c_d)]} = \kappa$$

where  $\kappa$  is a constant. Using the property that  $\exp(m)/\exp(n) = \exp(m - n)$  this becomes

$$\frac{f_p(x)}{f_d(x)} \frac{a_p}{a_d} \exp[-(a_p + a_d)s(x) + a_p c_p - a_d c_d] = \kappa.$$

Taking the natural logarithm of both sides, and using the property that  $\ln(mn) = \ln(m) + \ln(n)$ , we have

$$\ln\left(\frac{f_p(x)}{f_d(x)}\right) + \ln\left(\frac{a_p}{a_d}\right) - (a_p + a_d)s(x) + a_p c_p - a_d c_d = \ln(\kappa).$$

Solving for  $s(x)$  and renaming the collection of constant terms  $k$  gives (5). ■

**Proof of Equation(6):** The probability density function for party  $i = p, d$  is

$$f_i(x) = \frac{1}{\sigma\sqrt{2\pi}} \exp\left(\frac{-(x - \mu_i)^2}{2\sigma^2}\right),$$

which implies

$$\frac{f_p(x)}{f_d(x)} = \exp\left[\frac{-(x - \mu_p)^2 + (x - \mu_d)^2}{2\sigma^2}\right].$$

Substituting this likelihood ratio into equation (5) yields

$$s(x) = k + \left(\frac{1}{a_p + a_d}\right) \left(\frac{-(x - \mu_p)^2 + (x - \mu_d)^2}{2\sigma^2}\right).$$

Expanding the numerator and rearranging terms, this becomes:

$$s(x) = k - \left(\frac{1}{a_p + a_d}\right) \left(\frac{\mu_p^2 - \mu_d^2}{2\sigma^2}\right) + \left(\frac{1}{a_p + a_d}\right) \left(\frac{2\mu_p x - 2\mu_d x}{2\sigma^2}\right).$$

The first two terms are constant, which we call  $s_0$ , and a slight rearranging of the last term gives equation (6). ■



**Proof of Equation (11):** Any Pareto-optimal contract between the plaintiff and the capital market satisfies

$$\frac{f_p(x)}{f_0(x)} \frac{u'_p(t(x) - c_p)}{u'_0(x - t(x))} = k$$

where  $k$  is a constant. Because  $u'_i(z) = a_i \exp(-a_i z)$ , we have

$$\frac{f_p(x)}{f_0(x)} \frac{a_p \exp[-a_p(t(x) - c_p)]}{a_0 \exp[-a_0(x - t(x))]} = \kappa$$

where  $\kappa$  is a constant. The rest of the proof follows closely the proof of equation (5) and is omitted. ■

**Proof of Equation (12):** The proof closely mirrors the proof of equation (6) and is omitted.

**Proof of Equation (13):** Any Pareto-optimal contract between the defendant and the capital market satisfies:

$$\frac{f_0(x)}{f_d(x)} \frac{u'_0(-x + r(x))}{u'_d(-r(x) - c_d)} = k,$$

where  $k$  is a constant. Because  $u'_i(z) = a_i \exp(-a_i z)$ , we have

$$\frac{f_0(x)}{f_d(x)} \frac{a_0 \exp[-a_0(-x + r(x))]}{a_d \exp[-a_d(-r(x) - c_d)]} = \kappa$$

where  $\kappa$  is a constant. The rest of the proof follows closely the proofs of equations (5) and (6), and the details are omitted. The constant terms  $t_0 = (1 - t_1)\mu_0$  and  $r_0 = (1 - r_1)\mu_0$  allow the outside investors to break even on average. ■

**Coexistence of Inside and Outside Contracting.** *Suppose that the plaintiff and defendant purchase Pareto-optimal outside contracts from a competitive capital market as described in (12) and (13). Then, the parties derive no additional value from contracting with each other.*

**Proof:** The plaintiff's (subjective) certainty equivalent of the competitively-supplied contract is  $(1 - t_1)\mu_0 + t_1\mu_p - a_p t_1^2 \sigma^2 / 2$  where  $t_1$  is defined in (12). Let  $\tilde{\mu}_p = (1 - t_1)\mu_0 + t_1\mu_p$  and let  $\tilde{a}_p = a_p t_1^2$ . The plaintiff's certainty equivalent may be written as  $\tilde{\mu}_p - \tilde{a}_p \sigma^2 / 2$ . So, our funded plaintiff is in the same position as

a plaintiff with risk aversion coefficient  $\tilde{a}_p$  normally-distributed beliefs with mean  $\tilde{\mu}_p$  who is facing a naked trial.

Similarly, the defendant's certainty equivalent is  $(1 - r_1)\mu_0 + r_1\mu_d + a_d r_1^2 \sigma^2 / 2$  where  $r_1$  is defined in (13). This may be written as  $\tilde{\mu}_d + \tilde{a}_d \sigma^2 / 2$  where  $\tilde{\mu}_d = (1 - r_1)\mu_0 + r_1\mu_d$  and  $\tilde{a}_d = a_d r_1^2$ . So, our defendant is in the same position as an uninsured defendant with beliefs  $\tilde{\mu}_d$  and risk aversion coefficient  $\tilde{a}_d$  who is facing a naked trial. We will now show that there are no gains from trade between these two (fictional) parties.

The Pareto-optimal inside contract (6) is

$$s_1 = \frac{\tilde{\mu}_p - \tilde{\mu}_d}{(\tilde{a}_p + \tilde{a}_d)\sigma^2}$$

Substituting the expressions above, this becomes

$$s_1 = \frac{(r_1 - t_1)\mu_0 + t_1\mu_p - r_1\mu_d}{(a_p t_1^2 + a_d r_1^2)\sigma^2} = \frac{t_1(\mu_p - \mu_0) + r_1(\mu_0 - \mu_d)}{(a_p t_1^2 + a_d r_1^2)\sigma^2}.$$

Substituting  $\mu_p - \mu_0 = a_p \sigma^2 t_1$  and  $\mu_0 - \mu_d = a_d \sigma^2 r_1$  from (12) and (13),

$$s_1 = \frac{a_p \sigma^2 t_1^2 + a_d \sigma^2 r_1^2}{(a_p t_1^2 + a_d r_1^2)\sigma^2} = 1. \quad \blacksquare$$

**Proof of Lemma 1:** Using the definitions,  $s_1 > t_1$  if and only if  $\frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} > \frac{\mu_p - \mu_0}{a_p \sigma^2}$ . Canceling  $\sigma^2$  and cross multiplying, this becomes  $a_p(\mu_p - \mu_d) > (a_p + a_d)(\mu_p - \mu_0)$  or equivalently  $\mu_0(a_p + a_d) > a_d\mu_p + a_p\mu_d$ . Dividing both sides by  $a_p + a_d$  gives  $\mu_0 > \frac{a_d\mu_p + a_p\mu_d}{a_p + a_d} = \hat{\mu}_0$ . Similarly,  $s_1 > r_1$  if and only if  $\frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} > \frac{\mu_0 - \mu_d}{a_d \sigma^2}$ . Rearranging terms,  $a_d(\mu_p - \mu_d) > (a_p + a_d)(\mu_0 - \mu_d)$ , or equivalently  $\mu_0(a_p + a_d) < a_d\mu_p + a_p\mu_d$ . Dividing by  $a_p + a_d$  gives us  $\mu_0 < \frac{a_d\mu_p + a_p\mu_d}{a_p + a_d} = \hat{\mu}_0$ .  $\blacksquare$

**Proof of Equation (19):** Using expressions (1) and (8) we have

$$B^*(\cdot) - B^N(\cdot) = \frac{(a_p + a_d)\sigma^2}{2} \left[ \left( \frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} \right)^2 - 2 \left( \frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} \right) + 1 \right].$$

Rewriting,

$$B^*(\cdot) = B^N(\cdot) + \frac{(a_p + a_d)\sigma^2}{2} \left[ 1 - \frac{\mu_p - \mu_d}{(a_p + a_d)\sigma^2} \right]^2.$$

Next, expanding out expression (15) we have

$$B^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) = \frac{1}{2a_p a_d \sigma^2} [a_d(\mu_p - \mu_0)^2 + a_p(\mu_0 - \mu_d)^2],$$

which after some algebraic manipulation becomes

$$B^0(\cdot) = \frac{a_p + a_d}{2a_p a_d \sigma^2} \left[ \mu_0^2 - 2\mu_0 \left( \frac{a_d \mu_p + a_p \mu_d}{a_p + a_d} \right) + \frac{a_d \mu_p^2 + a_p \mu_d^2}{a_p + a_d} \right].$$

Recalling the definition of  $\hat{\mu}_0$  in (18), this may be rewritten as

$$B^0(\cdot) = \frac{a_p + a_d}{2a_p a_d \sigma^2} \left[ (\mu_0 - \hat{\mu}_0)^2 + \frac{a_p a_d (\mu_p - \mu_d)^2}{(a_p + a_d)^2} \right],$$

or equivalently

$$B^0(\cdot) = \left( \frac{a_p + a_d}{2a_p a_d \sigma^2} \right) (\mu_0 - \hat{\mu}_0)^2 + \frac{(\mu_p - \mu_d)^2}{2(a_p + a_d) \sigma^2}.$$

Finally, using the definition of  $B^*(\cdot)$  in (8) gives

$$B^0(\cdot) = \left( \frac{a_p + a_d}{2a_p a_d \sigma^2} \right) (\mu_0 - \hat{\mu}_0)^2 + B^*(\cdot). \quad \blacksquare$$

**Proof of Proposition 2:** Consider first the inside contract in (6) where  $s_1 = \frac{\mu_p - \mu_d}{(a_p + a_d) \sigma^2}$  and  $s_0$  is negotiated between the plaintiff and defendant.

With probability  $\pi$ , the defendant makes a take-it-or-leave-it contract offer to the plaintiff. The lump sum  $s_0$  would make the plaintiff indifferent between accepting the inside contract going to court where the plaintiff would receive a subjective value of  $\mu_p - a_p \sigma^2/2$ . So, when the defendant makes the offer, the plaintiff receives the outside option payoff of  $\mu_p - a_p \sigma^2/2$ . If the plaintiff could make a take-it-or-leave-it offer to the defendant instead, the plaintiff would choose  $s_0$  to make the defendant indifferent between the inside contract and a naked trial,  $s_0 + s_1 \mu_d + \frac{a_d s_1^2 \sigma^2}{2} = \mu_d + a_d \sigma^2/2$ . Rearranging terms, the plaintiff would offer  $s_1 = \frac{\mu_p - \mu_d}{(a_p + a_d) \sigma^2}$  and  $s_0$  where

$$s_0 = \mu_d + a_d \sigma^2/2 - s_1 \mu_d - \frac{a_d s_1^2 \sigma^2}{2}$$

The plaintiff's private subjective value from this is therefore

$$s_0 + s_1 \mu_p - \frac{a_p s_1^2 \sigma^2}{2} = \mu_d + a_d \sigma^2/2 - s_1 \mu_d - \frac{a_d s_1^2 \sigma^2}{2} + s_1 \mu_p - \frac{a_p s_1^2 \sigma^2}{2}.$$

$$= \mu_d + a_d \sigma^2 / 2 + s_1(\mu_p - \mu_d) - \frac{(a_p + a_d)s_1^2 \sigma^2}{2}$$

and, using (7) and (8), this becomes

$$\mu_d + a_d \sigma^2 / 2 + B^*(\cdot)$$

where  $B^*(\cdot)$  is defined in (8). So when the plaintiff has all of the bargaining power, the plaintiff can extract the defendant's maximum subjective willingness to pay plus the entire joint value of inside contracting.

Weighting the plaintiff's payoffs by  $\pi$  and by  $1 - \pi$ , we have the plaintiff's subjective value of the inside contract:

$$\pi \left( \mu_p - \frac{a_p \sigma^2}{2} \right) + (1 - \pi) \left( \mu_d + \frac{a_d \sigma^2}{2} + B^*(\cdot) \right).$$

This expression is decreasing in  $\pi$ . The plaintiff is subjectively worse off when the defendant's bargaining power increases. When  $\pi = \hat{\pi}$  the plaintiff's subjective payoff from the inside contract is

$$\left( \frac{a_d \mu_p + a_p \mu_d}{a_p + a_d} \right) + \left( \frac{a_d}{a_p + a_d} \right) B^*(\cdot) = \hat{\mu}_0 + \left( \frac{a_d}{a_p + a_d} \right) B^*(\cdot).$$

Now consider the plaintiff's subjective payoff from the outside contract. Using (12), the plaintiff's subjective value from the outside contract may be written as

$$(1 - t_1)\mu_0 + t_1\mu_p - \frac{a_p t_1^2 \sigma^2}{2} = \mu_0 + \frac{(\mu_p - \mu_0)^2}{2a_p \sigma^2}.$$

This is increasing in  $\mu_0$  for  $\mu_0 > \mu_p - a_p \sigma^2$ . When  $\mu_0 = \hat{\mu}_0$  defined in (18) this becomes

$$\begin{aligned} \hat{\mu}_0 + \frac{(\mu_p - \hat{\mu}_0)^2}{2a_p \sigma^2} &= \hat{\mu}_0 + \frac{(\mu_p - \frac{a_d \mu_p + a_p \mu_d}{a_p + a_d})^2}{2a_p \sigma^2} \\ &= \hat{\mu}_0 + \left( \frac{a_d}{a_p + a_d} \right) \frac{(\mu_p - \mu_d)^2}{2(a_p + a_d) \sigma^2} = \hat{\mu}_0 + \left( \frac{a_d}{a_p + a_d} \right) B^*(\cdot). \end{aligned}$$

Therefore the plaintiff's subjective payoff from the inside and the outside contract are exactly the same when  $\pi = \hat{\pi}$  and  $\mu_0 = \hat{\mu}_0$ .

Similarly, the defendant's subjective payment with inside contracting is

$$\pi \left( \mu_p - \frac{a_p \sigma^2}{2} - B^*(\cdot) \right) + (1 - \pi) \left( \mu_d + \frac{a_d \sigma^2}{2} \right).$$

This is an increasing function of  $\pi$ , so the defendant is better off when his own bargaining power is stronger. When  $\pi = \hat{\pi}$ , one can show as above that the defendant's subjective payment with the inside contract is

$$\hat{\mu}_0 - \left( \frac{a_p}{a_p + a_d} \right) B^*(\bullet).$$

Now we construct the defendant's subjective payment from the outside contract. Using (13), the defendant's payment is

$$(1 - r_1)\mu_0 + r_1\mu_p + \frac{a_d r_1^2 \sigma^2}{2} = \mu_0 - \frac{(\mu_0 - \mu_d)^2}{2a_d \sigma^2}.$$

this is increasing in  $\mu_0$  when  $\mu_0 < \mu_d + a_d \sigma^2$ . When  $\mu_0 = \hat{\mu}_0$  then the defendant's subjective payment from the outside contract

$$\hat{\mu}_0 - \left( \frac{a_p}{a_p + a_d} \right) B^*(\bullet).$$

When  $\pi = \hat{\pi}$ , this equals the defendant's payment with the inside contract. ■

**Proof of Equation (23):** Substituting the expressions for  $t_1$  and  $r_1$  from (12) and (13) into (16) gives

$$\begin{aligned} R^0(\mu_0, \mu_p, \mu_d, a_p, a_d, \sigma^2) &= \frac{\sigma^2}{2} \left( \frac{a_p(\mu_p - \mu_0)^2}{a_p^2 \sigma^4} + \frac{a_d(\mu_0 - \mu_d)^2}{a_d^2 \sigma^4} \right) \\ &= \frac{1}{2\sigma^2} \left( \frac{(\mu_p - \mu_0)^2}{a_p} + \frac{(\mu_0 - \mu_d)^2}{a_d} \right) \end{aligned}$$

Expanding and rearranging terms verifies that this is equivalent to

$$R^0(\bullet) = \frac{1}{2\sigma^2} \left( \frac{a_p + a_d}{a_p a_d} \right) \left[ \mu_0 - \left( \frac{a_d \mu_p + a_p \mu_d}{a_p + a_d} \right) \right]^2 + \frac{(\mu_p - \mu_d)^2}{2(a_p + a_d)\sigma^2}.$$

Using the definitions of  $\hat{\mu}_0$  in (18) and  $R^*(\bullet)$  in (9), this becomes

$$R^0(\bullet) = \frac{1}{2\sigma^2} \left( \frac{a_p + a_d}{a_p a_d} \right) (\mu_0 - \hat{\mu}_0)^2 + R^*(\bullet). \quad \blacksquare$$

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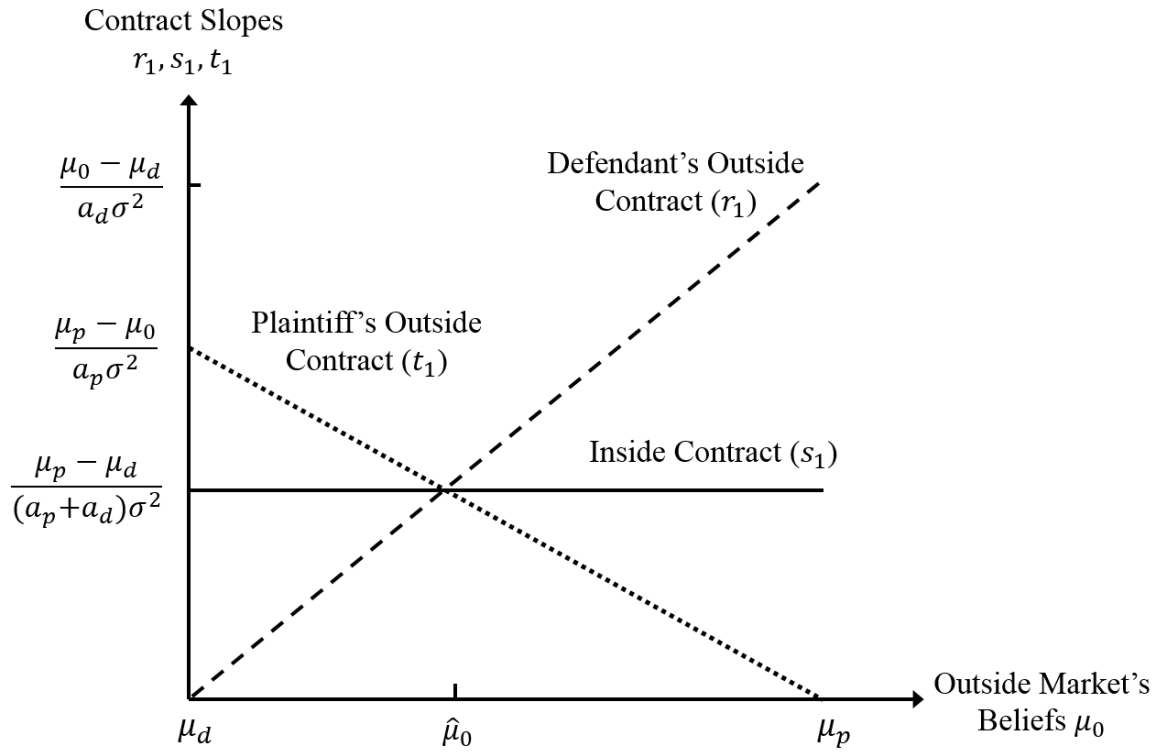


Figure 1: Inside and Outside Contracts ( $\mu_d < \mu_p$ )